terminate calls on the BOCs' *local* networks. Prior to the break-up, the Bell System local companies provided their long distance affiliate with a far superior quality of access to their local networks and customers than was being offered to the nonaffiliated "Other Common Carriers" ("OCCs").[53] For example, calls placed by BOC customers were in all cases automatically routed to their long distance affiliate whenever the customer dialed a call on a "1+" basis; OCC customers were forced to dial lengthy "access codes" and manually enter their billing account information. Additionally, the interconnection arrangements being provided by the BOCs to their long distance affiliate were far superior in a number of other qualitative respects; for example, BOC local and long distance billing was handled on an entirely integrated basis, and the BOC billing system was provided with "answer supervision" by the terminating carrier indicating when the called party answered the call as well as when the called party terminated the conversation by hanging up the phone. The BOC-affiliated long distance carrier was thus able to provide accurate long distance billing to its customers, whereas OCCs, whose interconnection arrangements with the BOCs typically did not include "answer supervision," would often bill for calls that were not answered or fail to bill for short calls that were.

33. The MFJ and subsequent implementing regulations focused heavily upon the so-called "equal access" requirement, a set of interconnection arrangements that was designed to end disparity in BOC/OCC traffic exchanges. Although the bulk of the "equal access" issues were resolved by the end of the 1980s, several sources of disparate treatment persisted until

---

53. The term "Other Common Carriers" ("OCCs") was used to refer to interexchange carriers other than AT&T.

as late as 1999.[54] In establishing specific rules for implementation of the Section 272(b)(1) "operate independently" requirement, the Commission has focused particularly upon the "equal access" concerns, directing that all operating equipment and facilities be separately owned, and that installation and maintenance services be provided separately to the BOC and its affiliate. The FCC has applied section 272(b)(1) specifically to forestall BOC affiliate advantages such as those formerly enjoyed by the integrated AT&T in terms of access:

> We conclude that a BOC may not discriminate in favor of its section 272 affiliate by: 1) providing exchange access services to competing interLATA service providers at a higher rate than the rate offered to its section 272 affiliate; 2) providing a lower quality service to competing interLATA service providers than the service it provides to its section 272 affiliate at a given price; 3) giving preference to its affiliate's equipment in the procurement process; or 4) failing to provide advance information about network changes to its competitors.[55]

As I shall discuss in more detail below (at para. 58), it now appears that at least one BOC — BellSouth — has recently attempted to flaunt this nondiscrimination requirement as well, offering more favorable rates for switched access to its long distance affiliate than are available to other IXCs.

34. Prior to "equal access," BOCs had the ability to — and did — preemptively direct their *local service customers' business* to their long distance affiliate *each time the local customer dialed an interLATA or intraLATA toll call* and by so doing prevented competing carriers from providing service to — "addressing" — the BOCs' customers. This enormous

---

54. Although the BOCs were required by the MFJ and the FCC to route *interLATA* calls to the interexchange carrier selected by the customer as the "Presubscribed Interexchange Carrier") ("PIC"), BOCs were permitted to route 1+ *intraLATA* calls to their own networks until as recently as 1999 — three years following enactment of the 1996 federal legislation. 47 U.S.C. § 271(e)(2)(B).

55. *Non-Accounting Safeguards Order*, at 21914.

competitive advantage was partially resolved via a two-pronged policy framework that coupled a *structural* remedy with active regulatory initiative and involvement. Specifically, by structurally separating (in fact, divesting) the BOCs from their long distance affiliate, the BOCs' *incentive to discriminate* was effectively eliminated, since such discrimination would no longer afford the BOCs with any financial or market advantage. Then, by imposing an affirmative "equal access" requirement, the BOCs were forced to interconnect with all long distance carriers — including their former affiliate — on the same or equivalent qualitative and financial terms.

35. It is noteworthy that both the structural and regulatory initiatives launched by the MFJ were confined strictly to the *interLATA* market; BOCs were not required to separate their local and *intra*LATA toll services, nor were they required to provide the same level of "equal access" to competing nonaffiliated *intra*LATA toll carriers.[56] As a consequence, the BOCs did not confront the same "indifference" with respect to their end-user customers' choice of *intraLATA* carrier as they did with respect to interLATA services, and continued to preemptively route customer's intraLATA calls to the BOCs own intraLATA service. Without a corresponding intraLATA "equal access" requirement, the BOCs not surprisingly continued to overwhelmingly dominate the intraLATA long distance market, and were able to maintain that largely unchallenged position until the "equal access" requirement was

---

56. The industry model envisioned at that time by framers of the MFJ allocated interLATA services to IXCs, while placing local and intraLATA toll and access services with the divested BOCs. Since IXCs were not expected to compete for intraLATA toll services, the lack of an "equal access" requirement with respect to this segment did not receive very much attention. The 1996 *Act* replaced the MFJ model with one in which competition would be permitted *and accommodated* at all levels, which required that the "equal access" and associated nondiscrimination concepts become applicable for all local and intraLATA services as well as for the interLATA segment that had been addressed in the MFJ.

ultimately extended to this segment, which did not occur until about 1999.[57] Until that date, the BOCs were able to — and did — leverage their local service monopoly to diminish competition in, and maintain their dominance of, the adjacent intraLATA toll market.

36. BOC entry into the in-region *interLATA* long distance market creates precisely the same potential for anticompetitive conduct and market advantage as prevailed in the intraLATA market during the period between the 1984 Bell System break-up and the 1999 completion of intraLATA equal access. While the matter of call-by-call preemption (the 1+ dialing advantage) has been explicitly addressed through first the interLATA and then the intraLATA "equal access" requirement, the BOCs still maintain and benefit competitively from yet another — and fully comparable — form of preemptive access to their legacy local service customers — the *"inbound marketing channel."*

37. There is a clear and unmistakable analogy between the predivestiture/pre-equal access "1+ dialing" advantage and the post-271 "inbound marketing channel" advantage that the BOCs presently enjoy. Most customers do not have a real choice as to their local carrier, and customers overwhelmingly call the incumbent LEC first.[58] Most of these callers are likely not contacting the BOC for the purpose of ordering — or even inquiring about — the

57. 47 U.S.C. § 271(e)(2)(B) provides that "a state may not require a Bell operating company to implement intraLATA toll dialing parity in that State before a Bell operating company has been granted authority under this to provide interLATA services originating in that State or before 3 years after the date of enactment of the Telecommunications Act of 1996, whichever is earlier."

58. Indeed, a *Mover's Guide* distributed by the United States Postal Service to residential customers when they file a Change of Address notice advises them to "call your local phone company a month before you move" and then proceeds to list specifically the operating areas and phone numbers for BellSouth, Qwest and Verizon. See Attachment 4 to this Declaration.

BOC's long distance services where available. Most are calling to order new or additional *local* service, to change their existing service, report a service problem, inquire about a billing issue, order optional features, to move their service to a new location, or to obtain information about new local services that might become available, such as ADSL. Each of these *inbound* contacts provides the BOC with an *opportunity* to *sell* long distance service. And although initiated by the customer for a different purpose, each of these in-bound calls is, in the end, initiated by the caller with the intention of dealing in some manner with telephone service issues. As long as the BOCs maintain their position of overwhelming market dominance in the local market — which they do — customers will have a strong propensity to contact "the phone company" — the BOC or other incumbent LEC — for local phone service, and this propensity is particularly evident in the residential and small business segments.

38. Once the BOCs have been contacted by the customer regarding local service, they are permitted to preemptively suggest to the consumer that the BOC affiliate handle all of the customer's interLATA calls. A customer's selection of a carrier other than the BOC affiliate requires that the customer take additional, affirmative steps to make such a choice, and most likely, choose to initiate another phone call to the selected interLATA carrier in order to choose the appropriate discount calling plan. Just as in the intraLATA market, placing these additional burdens upon consumers who might otherwise elect to do business with a non-BOC long distance carrier will discourage customer choice and thereby place competing IXCs at a significant disadvantage vis-a-vis the BOC affiliate. The extent of this disadvantage can be illustrated by the fact that, in the states in which the BOCs have obtained in-region entry authority, BOC affiliates have amassed long distance market share at an unprecedented rate. The California PUC ALJ, speaking to this very point, observed that:

> We find that Pacific's proposed joint marketing plans, detailed above in relation to § 709.2(c)(3), also pose a substantial possibility of harm to the intrastate long distance telephone market. The significant advantage afforded Pacific's long distance affiliate by Pacific's ability to market its affiliate's service to several million incoming customer service calls per year from its existing local service customers will unquestionably affect the other interexchange carriers. No other interLATA competitor in California has any similar massive opportunity to address incoming calls from potential interLATA customers. PBLD's potentially swift dominance of the intrastate interexchange telephone market could detrimentally impact competition in that sector.[59]

39. Actual BOC market penetration results as reported by BOCs in states where in-region interLATA entry has been authorized demonstrate the dramatic and unprecedented success that the BOCs have achieved in capturing market share. After approximately twelve months following its receipt of Section 271 authority in New York, Verizon Long Distance reported a New York residential market share of 20%.[60] In addition, Verizon's New York long distance market penetration continued to grow at an impressive rate beyond the first year. After 21 months of providing long distance service in New York, Verizon reported a New York long distance market share of 31.7%, and at the end of 2001, after two full years of 271 authority, Verizon reported a market share of 34.2%.[61]

40. Verizon's experience in New York is not anomalous. Nine months after receiving 271 authority in Massachusetts, Verizon reported a long distance market share of more than

59. *California PUC Draft 271 Decision*, at 247.

60. See Verizon Press Release, "Verizon Communications Post Strong Results for Fourth Quarter and 2000," February 1, 2001.

61. Verizon Press Release, "Verizon Communications Reports Solid 3Q Earnings and Provides Outlook For Remainder of 2001," October 30, 2001; Verizon Press Release, "Verizon Communications Reports Solid Results For Fourth Quarter, Provides Outlook for 2002," January 31, 2002.

20%, and indicated that sales results for Pennsylvania, where Verizon began marketing long distance services in late October 2001, were in line with early success rates in other Verizon states.[62] In Texas, where SBC received interLATA authority in June of 2000, SBC reported that after less than nine months its long distance affiliate, SBCS, had acquired 2.1-million of SWBT's 10-million local customers, representing a 21% share of the long distance market in the state.[63] SBC subsequently stopped releasing long distance market share figures on a state-by-state basis, making further state-level analyses no longer possible.

41. The economic value of this preemption advantage enjoyed by BOC affiliates acquiring interLATA customers is graphically illustrated when one considers the speed and ability of OCCs to gain interLATA market share without similar preemptive advantages. The transition to interLATA equal access began in 1985 and was substantially complete by the end of 1988. The 1985 beginning of the transition to equal access can be thought of as the date at which the elimination of economic barriers to interLATA long distance entry began. That event is then analogous to the BOCs' initial satisfaction of the 14-point checklist which, presumably, eliminated the economic barriers to entry into the local market. But the consequences of these otherwise comparable policy initiatives have been dramatically different: By the end of the fifth year (*i.e.*, by the end of 1990) following the commencement of interLATA equal access, all of the non-AT&T IXCs *combined* had collectively acquired 22.92% of presubscribed lines nationwide,[64] even with the aid of such "jump-start" market development measures as "equal access balloting" and automatic assignment of nonresponding

---

62. *Id.*

63. *SBC Investor Briefing*, April 23, 2001, at 7.

64. Federal Communications Commission, Wireline Competition Bureau, Industry Analysis Division, *Long Distance Market Shares, Fourth Quarter 1998*, March, 1999, ("*Long Distance Market Share Report*"), Table 2.1.

subscribers to a non-AT&T carrier. Of course, what the OCCs did not have, but which the BOCs do, is the massive legacy customer base to exploit. It is thus not surprising that in just two years following its entry into the New York interLATA market, Verizon was able to capture 34.2% of its New York in-franchise local service customers, a level of market share that *no single OCC has ever reached*[65] and that took *all of the OCCs combined* some 10 years (following the 1985 commencement of equal access) to accomplish.[66]

42. Compounding the formidable competitive advantage that is available uniquely to BOCs through their exploitation of the "inbound marketing channel" is the fact that the "price" that the BOC long distance affiliate "pays" to the BOC for such joint marketing "services" is woefully short of fair market value and thus constitutes a *de facto* cross-subsidy flowing from the BOC's regulated ILEC services to the BOC's competitive long distance services. As the California PUC ALJ noted, maintenance of separate affiliate requirements is *critical* to the CPUC's ability to detect and ultimately remedy such practices:

> Pac-West/WA's costing discussion and comparison regarding the proposed joint marketing plan clearly demonstrates cross-subsidization, and we find it very troubling. We trust that Pacific will very carefully re-examine the cost elements of its proposed joint marketing plan to ensure full compliance with our rules. Moreover, we reaffirm the auditing requirements that we designed in D.99-02-013 for Pacific and PBLD's joint marketing arrangements. Our confidence in non-structural safeguards has waned significantly over the last few years. Thus, if our required audits uncover cost allocation improprieties in the final joint marketing agreements, we will not hesitate to take the strongest action.

---

65. According to the most recent (2001) FCC IXC market share report, the largest non-AT&T IXC, MCI Worldcom, had a year-end 1999 residential market share of 16%, well below Verizon's two-year New York share of 34.2%. FCC Industry Analysis and Technology Division, *Statistics of the Long Distance Telephone Industry*, January 2001 (Data as of 1999), Table 24.

66. *Long Distance Market Share Report*, at Table 2.2.

> The record before us simply does not support the finding that there is no improper cross-subsidization anywhere within Pacific's proposal to provide long distance telephone service within California. Rather, the record includes documents that purport to show compliant costing allocations as well as documents that purport to show inappropriate allocations and underlying methodology. As of this date, the mandated audits have not yet been performed. However, we do find that our requirements for separate accounting records and for the examination of the cost allocation methodology for the provision of intrastate interexchange telecommunications service, pursuant to our affiliate transaction and cost allocation rules and O.P. 8 and 18 of D.99-02-013, will be integral in preventing, identifying and eliminating improper cross-subsidization.[67]

43. In view of the strong parallels between OCC entry in the 1980s and BOC entry today, I believe that the *results* of the earlier policy paradigm offer a useful and reasonable standard against which the current policy initiatives relative to BOC entry can be evaluated. That is, but for the BOCs' ability to exploit their inbound marketing channel, there is no *a priori* reason to expect their rate of market share growth to differ materially from that of the OCCs in the initial years following "equal access." Conversely, evidence of substantially greater BOC long distance market share growth serves to confirm the enormous value that Verizon and other BOCs obtain solely by virtue of their status as dominant local exchange carriers.

44. The extraordinary marketing advantage uniquely available to BOCs stemming from their use of the "inbound channel" has not been overlooked by Wall Street. As a February 8, 2001 Credit Suisse First Boston ("CSFB") report commented:

67. *California PUC Draft 271 Decision*, at 242; footnotes omitted.

> We've been watching this industry for almost 20 years and we have never seen consumer share gained at the rate of VZ in NY and SBC in TX (the former 20% share in 12 mos and the latter 18% share in 6 months).[68]

When a BOC obtains Section 271 authority, it gets not simply the right to enter yet another isolated line of business, but the right to *integrate* local and long distance service into a single package, to make the two services essentially indistinguishable from the consumer's perspective, and to leverage its dominance of the local market to similarly come to dominate the long distance market as well.

45. It is abundantly apparent that the *entire foundation* of the BOCs' long distance entry strategy rests upon their ability to exploit the inbound marketing channel and their legacy relationships with existing BOC local service customers. *De facto*, and ultimately *de jure*, integration of the BOC local and long distance services regardless of the requirements of Section 272 is a critical element of this strategy. Lest there be any doubt about this, the Commission should recall that BOCs have been permitted into the *out-of-region* long distance market since the enactment of the 1996 *Act* (i.e., February 8, 1996). At that time, *BOCs were permitted to provide interLATA long distance service in all out-of-region states*.[69] However, *none of the RBOCs availed themselves of this opportunity* except with respect to certain out-of-region services, such as Calling Card services, that could be marketed to their *in-region* local service customers. Moreover, rather than compete out-of-region, both SBC and Bell Atlantic chose instead to *acquire* via merger out-of-region BOCs, expressly foregoing their

---

68. "VZ: Analyst Mtg Provides Comprehensive '01 Outlook," Credit Suisse First Boston, 09:47am EST, 8-Feb-01 ("*Credit Suisse First Boston Report*").

69. Section 271(b)(2) provides that "A Bell operating company, or any affiliate of that Bell operating company, may provide interLATA services originating outside its in-region States after the date of enactment of the Telecommunications Act of 1996 ..."

opportunity for *immediate* long distance entry in those states but without the opportunity to leverage the ILEC subscriber base, for eventual long distance entry following Section 271 approval when they could pursue the fully integrated joint marketing strategy.

46. That SBC's marketing plans with respect to its long distance service are intimately linked to its legacy local service customer base is further confirmed by the fact that SBC's policy in its Section 271 states — Texas, Oklahoma, Kansas, Arkansas and Missouri — is to limit the availability of SBC long distance service to SBC local service customers only,[70] i.e., to not even offer or provide long distance service to customers of other ILECs or of CLECs. Thus, not only has SBC maintained its policy of not pursuing any out-of-region long distance entry, it does not even offer long distance service either to CLEC customers or to Independent ILEC customers *within the states in which SBC has received Section 271 authority*. Such revealed conduct compels the inescapable conclusion that the opportunity to engage in these practices appears to be the sole driver of SBC's interest in the long distance business. Credit Suisse First Boston makes the point profoundly clear in its comparison of (pre-merger) GTE's approach to selling long distance services through a separate CLEC affiliate vs. Verizon's and SBC's ability to offer long distance services directly to their ILEC customers:

> In stark contrast to Verizon's huge and quick 20% consumer LD share gains in NY State, LD subscribership was flat in the GTE franchise areas in '00 despite GTE's benefitting from similar pre-established branding and billing relationships. The difference is that GTE has not leveraged the inbound channel and also had been running its LD effort through its "CLEC", in effect forcing customers to switch to the GTE CLEC both their local service from GTE's ILEC and their LD service from another LD customer. Not very successful if you ask us and

70. See Attachment 5 to this Declaration. This is a print-out of the response I received from the SBC website when I attempted to order SBC long distance service using a hypothetical telephone number in a Texas exchange not served by SWBT.

> certainly worthy of change given the empirical evidence that VZ's and SBC's use of the inbound channel and separate LD sub (but not bundled with local) have been extraordinarily successful.[71]

47. As the Credit Suisse First Boston report observes, this preemptive use of the "inbound channel" by both Verizon and SBC to "sell" their long distance service to *new* local service customers has been the principal explanation for their extraordinary success in acquiring customers in the first year in which they have been permitted into the long distance business. Indeed, SBC was sufficiently satisfied with its early market performance in Texas that after only seven months the company *increased* its interstate long distance rates by over 10%. As reported in the *Ft. Worth Star-Telegram*, February 2, 2001:

> Southwestern Bell announced it was raising the interstate rate on its flagship plan from 9 cents a minute to 10 cents a minute for new customers seven months after entering the long-distance market in Texas. Current subscribers will see no change in their domestic U.S. calling charges, said Shawn Ramsey, a San Antonio-based spokeswoman for Southwestern Bell, a unit of SBC Communications.
>
> Ramsey defended the increase, which doesn't require approval by the state's Public Utility Board, by saying the plan is superior to many offered by the major long-distance services. "We beat the pants off of them," she said. "We've got great rates any way you slice or dice it." Asked if the higher rate reflects a need to boost profits, she said: "We've been in the market about eight months now. We've learned a lot and made a number of changes that reflect what we've seen. And we've changed our plan accordingly."[72]

48. Indeed, at least with respect to these types of sales at the time of the initial local service contact, the BOC need spend little if any resources actually advertising or otherwise marketing its long distance services. The inbound caller has already made the contact with

---

71. *Credit Suisse First Boston Report.*

72. "SW Bell raises interstate rate; current subscribers unaffected; PUC approval not needed," *Ft. Worth Star-Telegram*, February 2, 2001.

"the phone company" for basic telephone service and, unless that customer is a student of telecommunications industrial organization and regulation, he or she is as likely as not to accept the BOC's "recommendation" as the only and obvious choice.

A recent BOC-commissioned "study" claims that consumers will benefit from lower BOC long distance prices because BOCs with 271 authority are "profit-maximizing" across their access and retail toll services combined; if so, then the BOCs would be in violation both of access charge imputation rules as well as Section 272 separate affiliate requirements.

49. A recently released empirical study of Verizon and SBC pricing following their receipt of 271 authority in New York and Texas, respectively, suggests that in both instances the BOC ILEC entity and the Section 272 structurally separated long distance affiliate are not maintaining the "arm's length" relationship that is required by Section 272(b)(5) and, more generally, are operating vis-a-vis one another *as if the Section 272(a) and (b) structural separation requirements did not exist.* The study, "Does Bell Company Entry into Long-Distance Telecommunications Benefit Consumers?" by Jerry A. Hausman, Gregory K. Leonard, and J. Gregory Sidak,[73]("HLS") claims to have found "a statistically significant decrease of 8 to 12 percent in the average bill in states where BOC entry occurred as compared to the states without BOC entry."[74] I have examined the so-called empirical basis for the authors' various contentions and have identified a number of serious, indeed, fatal

73. Jerry A. Hausman, Gregory K. Leonard and J. Gregory Sidak, "The Consumer-Welfare Benefits from Bell Company Entry into Long-Distance Telecommunications: Empirical Evidence from New York and Texas" ("Hausman/Leonard/Sidak" or "HLS"), unpublished study, dated May 2002.

74. *Id.*, at 2.

deficiencies in their analysis.[75] Nevertheless, the study, which was commissioned by Qwest in support of its Section 271 applications,[76] advances a theoretical basis for the empirical results they claim to have obtained. If the authors' empirical findings and claims are accurate, however, the theoretical "double marginalization" explanation that they offer for this outcome would indicate that both Verizon in New York and SBC in Texas are in violation of the separate affiliate requirement.

50. Hausman *et al.* explain "double marginalization" as follows:

> Double marginalization occurs when two companies have a vertical supplier-customer relationship. The upstream company sets its margin to maximize its profits individually, while the downstream company does the same. If the upstream company begins to offer the downstream product also, it generally will set the final price of the downstream product to maximize its profits jointly. The company offering the combined product will often find that it can increase its profits by lowering the price of the final product below the combined price that would obtain in the previous situation.
>
> Suppose that a BOC's incremental margin on the provision of network access is \$0.02 per minute, while the IXC's incremental margin on residential long-distance service is \$0.04 per minute. The BOC will find it to be profit maximizing to lower the total margin from \$0.06 per minute because it earns both margins, rather than only a single margin (\$0.02 for access + \$0.04 for long-distance = \$0.06 total margin). The BOC would also be using two sets of

---

75. Selwyn, Lee L., "BOC Long Distance Entry Does Not Benefit Consumers," presented at the Department of Justice Telecom Workshop, "*The Drivers and Significance of Competition in Local Telecommunications: Empirical Evidence*," Washington, DC, July 23, 2002. Available at www.econtech.com/library/doj_072302.pdf

76. Although the authors do not cite the source of their funding in the paper, evidence adduced in the current Section 271 proceeding in Minnesota has identified Qwest as that source. *In the Matter of a Commission Investigation into Qwest's Compliance with Section 271(d)(3)(C) of the Telecommunications Act of 1996 that the Requested Authorization is Consistent with the Public Interest Convenience and Necessity*, Before the Minnesota Public Utility Commission, PUC Docket No. P-421/CI-01-1373, Qwest response to DOC Information Request 18059.

> facilities, local access and long-distance facilities, to earn this higher margin. When the BOC decreases the price slightly, it sells more access and more long-distance services and earns approximately $0.06 per minute. In contrast, if an IXC decreases the price, it only receives the additional margin from increased sales of long-distance service of $0.04 per minute. Thus, the BOC has a greater incentive to charge lower long-distance prices than does an IXC. Furthermore, when the BOC lowers the long-distance price, the IXCs will lower their prices, which will increase the number of long-distance minutes demanded and consequently the number of access minutes demanded from the BOCs.

51. The adoption by Verizon and SBC of a "double marginalization" pricing strategy, as Hausman *et al* believe has occurred, belies the repeated claims by the RBOCs that they no longer have market power in the local exchange and access services markets. HLS observe that:

> Although the original example of double marginalization was in the case of monopoly, it is [sic] applies as well to imperfect competition, which characterizes telecommunications markets because of the large fixed and common costs. The Areeda-Hovenkamp antitrust treatise, for example, observes that "[t]he double marginalization model appears to make robust predictions that vertical integration results in increased output and lower prices any time the affected markets are something less than perfectly competitive." Under current regulatory policies, access and long-distance services are both sold at prices exceeding marginal (incremental) cost, so as to cover the large fixed costs of local and long-distance networks. Although access reform since the Telecommunications Act of 1996 has decreased the BOCs' access margin, it has not eliminated the entire margin. Thus, double marginalization still leads to the prediction that BOC entry into the in-region interLATA market will lead to lower long-distance prices. Our econometric findings support this economic analysis, which has not been taken into account by the DOJ and FCC in their section 271 implementation analyses.[77]

If the authors' empirical findings and claims as to "double marginalization" are accurate, this condition would indicate that both Verizon in New York and SBC in Texas are in violation of

---

77. *HLS*, at 18, footnotes omitted.

both the Section 272(e)(3) imputation and the Section 272(a) and (b) separate affiliate requirements.

52. Moreover, such "double marginalization" will occur as between the BOC and its 272 affiliate *only when the two entities seek to maximize their joint profit* — i.e., when they explicitly *do not deal with each other at arm's length* as expressly required by Section 272(b)(5), and instead pursue a strategy that converts the "wall" that the *Act* sought to create between the BOC and long distance entities into a transparent and porous membrane whose purpose is entirely limited to serving as the perfunctory demarcation point for the required compliance postings and filings. The intent of the statute is to assure that the BOC's long distance affiliate gains no competitive advantage vis-a-vis nonaffiliated IXCs, which implies that it should view all payments to the BOC for both tariffed (e.g., access) and non-tariffed services as "costs" and make all pricing and output decisions without regard to the fact that such "payments" to the BOC will create offsetting profits in the BOC entity itself.

53. Consider, for example, the matter of the billing and collection services that are furnished by the BOC to the 272 affiliate. Where the 272 affiliate's customer is also a BOC local service customer (as I have noted, SBC's 272 long distance affiliate, SBCS, in fact, will *only* provide service to customers of the local SBC operating company[78]), the incremental cost to the consolidated enterprise of including a customer's long distance billing on the local service bill — which will need to be prepared and mailed, and the payment received and processed, whether or not the customer subscribes to the affiliate's long distance service — is

78. The SBC website indicates that "SBC Long Distance provides long distance where arrangements exist with local providers in the SBC Southwestern Bell Telephone Company service area. Queries to the cite indicate that this service is not available to CLEC customers. http:/www.SWBell.com/Products_Services/Residential/ProdInfo_1/1,1973,187--6-3-15,00.html

extremely small. No additional envelope or postage will be required,[79] and the costs of receiving and processing a payment will be entirely unaffected whether or not the payment includes the long distance charges.

54. According to the Section 272(b)(5) disclosure information provided on Verizon's website, Verizon New York's charge to its Verizon Long Distance ("VLD") affiliate for billing and collection services is $1.15 per account (plus postage, which varied based on weight).[80] Since the incremental cost to VNY for these services is at or near zero, especially considering that postage is similar if not exactly the same were Verizon to bill only for local service, virtually all of the $1.15 "cost" to VLD represents "profit" to VNY; from the standpoint of the consolidated enterprise, then, any such "payments" by one entity to another are essentially a "wash" and can be ignored if Verizon is following a "maximizing joint profits" double marginalization strategy. By contrast, other long distance providers not affiliated with Verizon will incur real out-of-pocket costs for the billing and collection functions, whether purchased from Verizon at the same terms as are nominally being "offered" to VLD, or are accomplished via stand-alone billing and collection activities undertaken by the IXC.

55. The "double marginalization" theory also raises serious concerns as to BOC compliance with cost imputation requirements and the opportunities *and incentives* available to them to impose price squeezes on their rivals. If VNY/VLD and SWBT/SBCS pricing conduct is driven by the goal of maximizing joint profit, it is then necessary for the

---

79. In most cases, only one or two additional pages of billing will need to be produced, and can be included in the same envelope with no additional postage.

80. http://www.verizonld.com/pdfs/VLDTransactionDetailWebPage1.pdf

downstream entity (VLD or SBCS) to essentially ignore any "payments" it makes to the upstream entity (VNY or SWBT) in setting its retail prices, and in fact to base those prices solely upon the underlying joint costs of both entities' services. Return to the HLS example where they posited that the access charge produces a $0.02 profit for the BOC entity and the retail long distance service produces a $0.04 "profit" relative to the downstream long distance affiliate entity's payment of access charges and incurrence of other costs. Now suppose that the two entities determine that the profit-maximizing price of the long distance service should be reduced by $0.02, bringing the per-minute joint profit to $0.04. Nonaffiliated IXCs would be forced to reduce their prices by a like amount in order to remain competitive, slashing their profit margins by 50% (i.e., from $0.04 to $0.02). They would still be forced to pay the full price of access to the BOC entity, which would continue to earn the full $0.02 access profit on all such purchases. Combining this with other "double marginalization" pricing and transactional incentives, such as billing and collection services and joint marketing, any semblance of "imputation" or "parity" in the pricing of services to nonaffiliated IXCs would be eradicated.

56. AT&T has alleged that SWB in Texas is ignoring access charges in exactly the manner described by HLS. Based in part on information provided as part of the requirement of Section 272(b)(5) that all affiliate transaction between the BOC and its Section 272 affiliate must be made at arm's length, reduced to writing, and made available for public inspection, AT&T filed a complaint with the Public Utility Commission of Texas on July 30, 2001 claiming that SBC and SBCS were engaging in exactly the type of double marginalization that HLS describe. As AT&T explains:

> When SWBT and SWB-LD sell intrastate switched long distance service at a rate of 6 cents per minute, the net revenue to SWB-LD, after paying SWBT's charges for switched access services, is approximately 0.33 cents per minute. However, based on public information in contracts between SWBT and SWB-LD

> filed on the SBC website, AT&T estimates that SWB-LD has a minimum of additional billing and marketing expenses of at least 3.4 cents per minute solely attributable to expenses incurred from affiliate transactions. In addition, SWBT and SWB-LD witness have filed sworn testimony at the FCC that indicates SWB-LD incurs an additional expense of 1-2 cents per minute for underlying carrier expenses. These expenses of at least 10-11 cents per minute cannot be fully recovered under SWB-LD's existing pricing structure. Moreover, it should be recognized that for certain rate plans, SWBT and SWB-LD explicitly recognize, and tout, that a customer's cost of SWBT and SWB-LD intrastate long distance telephone service can be less than a penny a minute-- significantly below the cost of switched access service alone. Based on the foregoing, AT&T respectfully submits that at least several of SWBT's and SWB-LD's current rates for intrastate long distance service, not to mention interstate long distance service, are below cost and predatory.

The facts offered by AT&T indicate that SWBT and SWB-LD have been violating the imputation requirements of Section 272(e)(3). Although Section 272(e)(3) is not covered by the sunset provision being considered by the Commission at the present, the information enabling AT&T to determine the existence of predatory pricing would no longer be available were this Commission to allow Section 272(a) and (b) to sunset.

57. If VLD was truly maintaining an arm's length, separate affiliate relationship with Verizon New York, it would be forced, when setting its own retail prices, to give effect to these account-specific payments to VNY as representing out-of-pocket *costs*. VNY would not, for example, be able to offer no-monthly-fee discount rate plans if it were subject to fixed per-account expenses. In fact, of course, VLD introduced precisely this type of pricing as soon as it was permitted to begin offering interLATA services in New York and has maintained this same pricing policy both in New York and in other Verizon 271 jurisdictions ever since. VLD and VNY are jointly behaving precisely as Hausman *et al.*'s "double marginalization" theory would suggest. Hence, it is not the "increased competition" resulting from VLD's long distance entry that brings prices down, it is the fact that the long distance and ILEC entities are acting *in concert* and not at arm's length, that they are working together

to maximize joint profit rather than their respective individual profits, that "explains" the empirical results that Hausman *et al.* claim to have identified. And it is precisely that type of *in concert* conduct that is expressly prohibited.

58. A graphic demonstration of the BOCs' potential ability to favor their own long distance business unit can be found in a "contract tariff" for switched access services that BellSouth recently introduced.[81] The discrimination is accomplished by tying a succession of "discounts" to "growth" in aggregate switched access usage over the five-year term of the contract tariff. As a new entrant into the in-region long distance market, the BOC affiliate starts out with minimal switched access demand, and thus will have little difficulty achieving a relatively high *rate* of growth. By contrast, the existing IXCs, some of which may be purchasing considerably more switched access service than the BOC affiliate will at the outset, are not likely to experience comparable *rates* of growth; indeed, to the extent that the BOC affiliate is successful in taking customers away from the IXCs, those IXCs may actually be experiencing *negative* growth. In any event, if the IXC is already purchasing quantities of switched access services that exceed the upper bound of the discount range — 4,401,406,922 minutes in the case of BellSouth's tariff — the putatively "available" discount price would as a practical matter not be available to carriers other than the BOC affiliate.[82] The effect of this growth-driven pricing device is ultimately to afford the BOC long distance affiliate lower rates than would be available to other IXCs with which it competes. Of course, if the

81. BellSouth Telecommunications, Inc., FCC No. 1, 520th Revised Page 1, 8th Revised Page 9.0.9, Effective May 18, 2002.

82. I have no specific knowledge that BellSouth Long Distance, the BellSouth Section 272 affiliate, is actually purchasing switched access services out of this contract tariff. However, the *fact* that this type of tariff has been introduced serves to demonstrate the *opportunity* that a BOC would have to favor its affiliate in the guise of a generally available tariff offering.

separate affiliate requirement is allowed to sunset, the BOC's long distance business unit (which may then be formally integrated into the BOC ILEC entity) will no longer be required to "buy" tariffed switched access services at all, and will instead be allowed simply to utilize the BOC's network access resources subject only to the far more malleable "imputation" requirement of Section 272(e)(3).

59. Importantly, if the separate affiliate requirement is allowed to sunset and the Section 272(b)(1) "operate independently" and 272(b)(5) "arm's length" requirements are eliminated, BOCs will no longer be under any obligation to "sell" access services to their long distance business units at tariff rates. The sole remaining "safeguard" against discrimination with respect to access services will be Section 272(e)(3), which is not subject to the sunset provision. Section 272(e)(3) requires the BOC to "... impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service." "Imputation" requirements of this type are applied by state commissions in the case of ILEC-provided competitive *intraLATA* toll services, but due to the absence of explicit access charges, precise application of such rules is particularly difficult. ILECs have argued, for example, that they are free to aggregate different services together in demonstrating that the imputation requirement has been satisfied, which may permit certain services to be priced below the imputation level only to be offset (i.e., cross-subsidized) by others whose prices exceed the applicable access charges. Such contentions have been rejected by state commissions,[83] but only after the practice had been underway for some

---

83. *See, e.g. Application of Qwest Corporation for an Increase in Revenues,* Oregon Public Utilities Commission, Order no. 01-810, 2001 Ore. PUC LEXIS 449, September 14, 2001, (order unpaginated, at "Access Charge Imputation" section), and *Application of US West Communications, Inc., for the Commission to Open an Investigatory Docket to Eliminate on*

(continued...)

time and following often protracted litigation. Proper application of an imputation requirement such as that contained at Section 272(e)(3) would require the BOC to demonstrate that its retail price exceeds the sum of the imputed access charges together with all costs incident to the value-added (long distance) services of which those access services are a component. Short of protracted complaint proceedings, I am not aware of any remaining mechanism, once the separate affiliate requirement has been permitted to sunset, that would permit the Commission or affected competitors to verify compliance with Section 272(e)(3).

60. As another example of joint BOC/affiliate pricing actions whose effect is to create a price squeeze for competing providers, consider the types of "tie-in" arrangements that Verizon Long Distance and Verizon New York have pursued as part of their "joint marketing" program. In New York, Verizon Long Distance ("VLD") was offering a $4.60 "credit" when a customer selected the basic VLD Schedule "C" ($0.10 per minute, no minimum, no monthly charge) calling plan and also subscribed to *Verizon New York*'s "Value Pack" service, a package of local exchange service and selected vertical features.[84] The VLD Schedule C rate plan was targeted at the relatively low-use customer who would be attracted by the absence of either a monthly charge or minimum usage commitment. If, for example, such a customer were to make no long distance calls at all during a given month, VLD would sustain a "loss" of at least $4.60 in that it would still have to "pay" the credit to

---

83. (...continued)
an Expedited Basis the Requirements that US West Impute Switched Access Rates into the Price Floor of its IntraLATA Long Distance Service, Colorado Public Utilities Commission, Docket No. 00A-201T, 2001 Colo. PUC LEXIS 133, January 24, 2001, at *16.

84. Bell Atlantic Communications, Inc. d/b/a Verizon Long Distance, New York PSC Tariff No. 1, Original Promotional Attachment No. 5. Package No. 1 Promotion and Rate Schedule (Section 3.5.3).

Verizon New York while receiving no offsetting long distance revenue from the customer. Verizon New York, however, would realize $17.99 in actual revenues from the customer (the price of Value Pack service)[85] plus the additional $4.60 "payment" from Verizon Long Distance. VNY gains $22.59 while VLD "loses" $4.60, which still results in a net gain to the consolidated Verizon bottom line of $17.99, erasing the VLD "loss" when examined at the enterprise level. VLD's ability to offer this "promotion" and to potentially sustain the "losses" arising therefrom is solely and uniquely attributable to its affiliate relationship with the Verizon BOC. Verizon has just announced the availability in its Section 271 states of several new "packages" of local, long distance and DSL services under the brand name "Veriations℠" that offer discounts of up to $15 if the customer orders a package consisting of local service with unlimited intraLATA calling, 14 custom calling features, DSL and Verizon (interLATA) Long Distance.[86] It's not clear how this $15 discount will be allocated as between the VNY and VLD entities, but from the standpoint of the parent company, it doesn't actually matter.

61. Of course, from the perspective of any *competing* non-affiliated interexchange carrier attempting to make a comparable "promotional" offer, it certainly does matter. That same $4.60 "credit" (and whatever new "credit" is associated with the *Veriations*℠ package) would be a real *cash payment*, representing a true out-of-pocket cost to the IXC. In Verizon's case, even though the inter-affiliate "payment" is (presumably) actually being recorded on the two entities' respective books, VLD is behaving as if no such "payment" is actually taking place.

---

85. http://www22.verizon.com/foryourhome/SAS/StateSelector.asp?ID=choosefeat, accessed 07/23/2002.

86. Verizon News Release, "Verizon Adds DSL to High Value Service Bundle," July 23, 2002.

The effect of these "promotional" or "tie-in" offers is to impose an anticompetitive price squeeze on VLD's long distance rivals.

The integrated relationship between the BOC and its Section 272 Affiliate is also reflected in distorted inter-affiliate pricing related to joint marketing of local and long distance services.

62. Verizon New York's provision of "joint marketing" services to VLD, the 272 affiliate, provides perhaps an even more compelling example of conduct whose effect is to ignore the nominal existence of the separate long distance affiliate. A BOC's authority to engage in joint marketing of its own local services with its affiliate's long distance service is found at Section 272(g)(3) of the federal *Act*, which operates to exempt a BOC's joint marketing of local and long distance service from the broader nondiscrimination requirements of Section 272(c):

> 272(g)(3): RULE OF CONSTRUCTION- The joint marketing and sale of services permitted under this subsection shall not be considered to violate the nondiscrimination provisions of subsection (c).

The Section 272(g)(3) joint marketing carve-out, however, is limited solely to the "nondiscrimination provisions" of Section 272(c), which is found at 272(c)(1), and does not exempt such joint marketing activities from 272(c)(2), which requires that a Bell operating company

> shall account for all transactions with an affiliate described in subsection (a) in accordance with accounting principles designated or approved by the Commission.

Nothing in subsection 272(g)(3) in any way exempts a BOC or its section 272(a) interLATA affiliate from the requirements of Section 272(b).

63. Disclosures and postings that Verizon and SBC have been required to make with respect to Section 272(b) affiliate transactions confirm that there are extensive and uncompensated information flows going from the BOC entity to the long distance affiliate, and that the affiliate is not being required to pay the BOC entity anything remotely close to the full and fair market value of such information and for the services that it receives from the BOC. In addition to furnishing personnel to support the joint marketing function, Verizon New York also provides its long distance affiliate with unfettered access to VNY's customer base and to the *inbound* customer-initiated contacts that arise as a consequence of VNY's dominant control of the New York residential local service market. Competing long distance providers must engage in extensive advertising, direct mail, and telemarketing to promote their service, and do not get anywhere near the quantity of inbound customer contacts as does the BOC, and those which IXCs do receive are primarily the result of the IXCs' advertising and other promotional efforts, undertaken at not inconsiderable cost to those IXCs.

64. Customer acquisition is among the most costly aspects of an interexchange carrier's operation. Without the benefit of the embedded ubiquitous customer base that is uniquely available to VLD, other IXCs must pursue active marketing strategies involving extensive media advertising, telemarketing, direct mail, and special promotions (cash, airline miles, etc.). When spread over the number of sales that are actually consummated, these costs can amount to hundreds of dollars per customer acquired. I am aware of at least one analysis that has put such cost at "up to \$300 to \$600 in sales support, marketing and commissions" per customer acquired.[87] The prevailing industry customer acquisition cost represents the fair market value of the customer acquisition services that a BOC provides to its 272 affiliate.

---

87. See Borna, Claude, "Combating Customer Churn," in *Business and Management Practices,* Vol. 11, No. 3; Pg. 83-85; ISSN: 0278-4831, Horizon House Publications, Inc., Telecommunications Americas Edition (March, 2000).

Yet according to Verizon's 272(b)(5) disclosures, VLD's "payments" to VNY for customer acquisition/joint marketing services are only $7.71 per contact;[88] SBC has identified the amount of such charges by its Texas BOC, SWBT, to the SBCS long distance affiliate at $9.90 per acquisition.[89] The magnitude of such payments is woefully short of the fair market value of these services and of the customer information that is being beneficially furnished by the BOCs to their affiliates. Through its use of the joint marketing channel, Verizon LD is able to save hundreds of dollars in marketing costs per customer.

65. Verizon and SBC improperly price joint marketing services using Fully Distributed Cost methodologies instead of Fair Market Value. The Commission explicitly requires that BOCs price all services provided to their Section 272 Affiliate that are not subject to tariff or Prevailing Company Pricing, at the higher of fair market value or fully distributed cost. Should the service not be available on the open market, this Commission required that a BOC *estimate* a fair market value.[90] Yet instead of the conducting the required study and estimating the inbound channel's value, Verizon presented the Section 272 Auditors with a

88. http://www.verizonled.com/pdfs/exhibit46zhamendment34.pdf

89. http://www.sbc.com/public_affairs/regulatory_documents/affiliate_agreements/300-993pa5-02.xls, accessed 7/25/2002.

90. In its *Accounting Safeguards Order*, at 17610, the Commission sets forth "the baseline for a good faith determination of fair market value by requiring carriers to use methods that are routinely used by the general business community." The Commission anticipated that some services would be unique and found, "[w]hen situations arise involving transactions that are not easily valued by independent means, we require carriers to maintain records sufficient to support their value determination." Finally, the Commission notes, "nothing discussed here exempts carriers from their statutory obligation under section 220(c) to justify their accounting entries."

letter stating that "FMV could not be obtained for these services."[91] Moreover, Verizon failed to explain why it did not obtain an *estimate* of the fair market value for these services.

66. It is instructive to compare and contrast Verizon's inter-entity pricing practices as between billing and collection services, on the one hand, and customer acquisition/joint marketing services, on the other. Since VNY offers and in fact provides billing and collection services to nonaffiliated IXCs, it is required to "charge" the same price for such services to its Section 272 affiliate as it does with respect to equivalent services furnished to nonaffiliated entities.[92] Not surprisingly, VNY's "price" for these services has been set at "fair market value," well in excess of its actual incremental cost. By contrast, VNY is *not* required to provide "joint marketing" services to nonaffiliated IXCs,[93] and by extension is not required to "offer" comparable or nondiscriminatory terms and conditions with respect to such services to nonaffiliated entities. Not surprisingly, VNY prices these services at what it claims to be fully-distributed cost ("FDC"),[94] resulting in a per-transaction "price" of only $7.71, a minute fraction of the fair market value of the customer acquisition services that it provides to VLD.

67. There is thus no evidence that the dollar amounts being reflected on the two entities' books bear any resemblance to the proper valuation of the services being provided, i.e., the

---

91. Verizon Communications Inc. Section 272 Biennial Agreed-Upon Procedures Engagement, filed in *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, Filed February 6, 2002, Appendix A at 21.

92. 47 U.S.C. § 271(c)(1).

93. 47 U.S.C. § 272(g).

94. *Supra*, footnote 88.

amounts that firms dealing with each other on a truly arm's length basis would demand. The conduct of VNY/VLD and SWBT/SBCS transitions are, indeed, consistent with the "double marginalization" theory, and *inconsistent* with any finding that anything beyond "lip-service" is being afforded by either RBOC to the Section 272(a) and (b) separate affiliate requirements.

The Section 272 separate affiliate requirement provides an essential transition between the former BOC long distance line-of-business restriction and a possible future in which the BOCs' market power with respect to local telecommunications access and services will have been eroded by the arrival of effective competition.

68. Section 271 was adopted as a *replacement* for the MFJ long distance line of business restriction, and established a process by which BOCs could enter the "in-region" long distance market provided that they implemented a series of specific measures that were to have the effect of irreversibly opening their previously monopolized local telecommunications markets to competitive entry. To the extent that the *local* market itself becomes competitive, the BOCs' ability to exert market power in the adjacent long distance market would be attenuated. Conversely, however, to the extent that competition *fails to develop* in the local services market, the BOC will then have both the incentive and the ability to exert market power in, and ultimately to remonopolize, the adjacent long distance market.

69. Since the MFJ, competition in the long distance market has thrived — and as a result prices have sharply decreased — in the nearly two decades since the MFJ first went into effect in January, 1984. The principle generally underlying Section 271 is that once there is sufficient competition in the *local* service market, it will then no longer be possible for a BOC to extend its local monopoly into the adjacent long distance market. The existence of but a *single* facilities-based competitor somewhere in any state — one of the threshold

conditions that a BOC must satisfy to obtain Section 271 approval[95] — is clearly not by itself sufficient to constrain the incumbent BOC's exercise of market power.

70. Congress established the Section 272 separate affiliate requirement and, in particular, the 272(b)(1) "operate independently" and 272(b)(5) "arm's length" provisions, specifically to wall-off the BOC ILEC and IXC entities from acting in concert to the detriment of long distance competitors. For so long as the BOCs maintain market power with respect to local services and local network access, they retain both the ability and the incentive to exploit preexisting customer relationships and the "inbound marketing channel" with respect to new customers to direct and to divert customers to their long distance offerings.

As a result of the BOCs' local market power, CLECs are unable to enjoy the same "double marginalization" benefits, a factor that ensures the BOCs and their affiliates will be able to expand their already substantial long distance market share to monopoly levels.

71. Verizon and SBC's ability to gain significant long distance market share is undoubtedly due to their local market power. As I have discussed above, the pricing plans offered by the BOC Section 272 affiliates are premised upon the ability of the BOC and its Section 272 affiliate to operate as if interaffiliate payments for fixed costs such as billing did not exist. Virtually all marketing costs associated with customer acquisition were avoided by the Section 272 affiliate, despite the clear requirement of Section 272(b)(5) that the BOC marketing services should have resulted in arm's length marketing fees paid by the 272 affiliate to the BOC. Avoiding these costs is the only economic reason why the BOC interLATA affiliates are able to offer pricing plans such as their no-minimum, no-monthly fee offer.

95. 47 U.S.C § 271(c)(1)(A).

72. BOC local market power allows integrated offers that simply are not possible for competitors to match. As the default local service provider, the BOC does not need to engage in additional advertising or customer acquisition costs to attract local customers, and once the local customers are acquired, the BOC is allowed to preemptively sell the customer the affiliate's long distance service. Even assuming that a CLEC were able to attract a market share approaching that of the BOCs, the CLEC's relatively new position in the local market does not allow the CLEC to enjoy similar cost avoidance. While a CLEC's long distance service would enjoy similar customer acquisition and billing benefits as the BOC affiliate, the CLEC's *local* service provision would be required to incur massive marketing outlays in order to attract local customers, at costs that are likely to be similar to or higher than those required to attract long distance customers. Those marketing costs, unique to CLECs, would increase the CLECs' cost of providing service above that of the BOC.

73. The purpose of Section 272 was to prevent exactly this kind of integrated pricing until CLECs were similarly positioned to take advantage of the same type of economies. CLECs will not be so positioned until the BOC no longer enjoys market power in the local market. As long as the BOC is permitted to exploit its captive relationship with the vast majority of local service customers to market and sell its affiliate's long distance services, BOC long distance shares will grow rapidly and non-BOC IXCs will suffer a precipitous decline in customers and demand. Faced with such losses, IXC costs will rise and at least some IXCs will be forced to exit the business, further exacerbating the situation and affording the BOCs an opportunity to remonopolize the nation's long distance market.

Conclusion

74. The Section 272(a) and (b) separate affiliate requirement and the Section 272(c) and (e) nondiscrimination requirements were included in the 1996 *Act* specifically to limit the BOCs' ability, following their receipt of Section 271 in-region interLATA authority, to leverage their market power in local exchange and access services into the adjacent and competitive long distance market. The BOCs' market power with respect to local exchange and access services has not materially diminished since the February 1996 date of enactment. The need to wall-off the BOCs' competitive long distance entity from their largely monopolistic local service operation is as strong and important today as it was six years ago and, if anything, there is now a compelling need to *strengthen* the Section 272(b) structural separation requirements in light of actual "on the ground" experience with BOC in-region long distance activities. To the extent that, by virtue of their continuing dominance of the market for local and access services, the BOCs can continue to operate the two nominally separate entities as if they were fully integrated, to pursue pricing and marketing strategies that are designed to maximize joint profit, to ignore imputation requirement, to impose price squeezes upon competing CLECs and IXCs, and to cross-subsidize their long distance business by failing to compensate monopoly local service ratepayers for the value that the long distance business gains from inter-affiliate transfers, the prospect of near-total and rapid remonopolization by the BOCs of the nation's long distance market is quite real.

75. Congress established the Section 272 separate affiliate and nondiscrimination requirements and, in particular, the Section 272(b)(1) "operate independently," 272(b)(5) "arm's length," and Section 272(e)(3) "imputation" provisions, specifically to prevent the BOC ILEC and IXC entities from acting in concert to the detriment of long distance competitors. Section 272 was designed to prevent collusive, discriminatory and exclusionary practices by a BOC in

the operation of its long distance business until CLECs were similarly positioned to take advantage of the same type of integration economies. CLECs will not be so positioned until the BOC no longer enjoys market power in the local market. As long as BOCs are permitted to exploit captive relationships with the vast majority of local service customers to market and sell long distance services, BOC long distance shares will grow rapidly and non-BOC IXCs will suffer a precipitous decline in customers and demand. Faced with such losses, IXC costs will rise and at least some IXCs will be forced to exit the business, further exacerbating the situation and affording the BOCs an opportunity to remonopolize the nation's long distance market.

76. While the Section 272 separate affiliate requirement cannot *guarantee* that BOCs will not engage in cross-subsidization, discrimination, price squeezes or other anticompetitive conduct, the retention of the separation requirement clearly makes such behavior somewhat more difficult and in any event facilitates its *detection*. It is critical that the Commission retain — and strengthen — the separate long distance affiliate requirement until such time as the BOC no longer dominates the local service market in the geographic area and consumer or business market in which it provides service.

The foregoing statements are true and correct to the best of my knowledge, information and belief.

LEE L. SELWYN